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QUESTION PRESENTED

Jurisdiction of claims under the Exchange Act is vested exclusively in the district courts. 15 U.S.C. §78aa. SEC rule 14d-10, the so-called "all-holders, best-price rule", promulgated under Sections 14(d)(7)f and 14(e) of the Act, requires shareholder equality "during [a] tender offer." In this class action proceeding, the Ninth Circuit held, *inter alia*, that a tax-driven special stock arrangement between Matsushita and Lew Wasserman, MCA's chairman, violated the rule, and that a jury could so find with respect to a $21,000,000 bonus paid to Sidney Sheinberg, MCA's chief operating officer.

This federal class action proceeding has been vigorously litigated. By contrast, petitioners' counsel represented to the district court that a pending Delaware class action raising only state law claims was "not being prosecuted in any way" after the state court had rejected a settlement as "illusionary", characterized the state law claims as "at best, extremely weak," and had asserted that the federal claims alone had value. No state class had been certified, and no litigation activity occurred for eighteen months in Delaware. After respondents' merits brief had been filed in the Ninth Circuit, petitioners announced another Delaware settlement. In it, the federal claims of non-opt-outs purportedly were released, although Delaware law states that it is ultimately for the federal courts to determine the effect of the release on Exchange Act claims. The Delaware court approved the settlement without making any inquiry into the representatives' class status or the adequacy of their representation. The court found the class benefits to be "meager", and stated that "suspicions abound" of collusion.

Did the court below err in refusing to give preclusive effect to a Delaware settlement and release to the extent that the federal claims were factually and legally unrelated to any state law claims?

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No. 94-1809

IN THE

SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1995

MATSUSHITA ELECTRIC INDUSTRIAL CO., LTD. AND MATSUSHITA HOLDING CORPORATION,

Petitioners,

v.

LAWRENCE EPSTEIN, et al.,

Respondents.

ON A WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENTS

STATUTES INVOLVED

28 U.S.C. §1738 is quoted in petitioners' brief. In relevant part, section 27 of the Exchange Act, 15 U.S.C. §78aa, provides:

> The district courts of the United States . . . shall have *exclusive* jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to *enforce* any liability or duty created by this chapter or the rules and regulations thereunder.[1]

[1] *Emphasis supplied through this brief, unless otherwise indicated.* "Pet. App." refers to the appendix on certiorari; "J.A." to the Joint Appendix. Documents contained in the records of the district court and the court of appeals are designated as "D.R." and "Cir. R.", respectively. References to the Reporter's Transcripts included in the Excerpts of Record

28 U.S.C. §1291 provides that the "courts of appeals . . . shall have jurisdiction of all appeals from all final decisions of the district courts of the United States . . ."

STATEMENT OF THE CASE

A. Introduction.

This petition arises out of Matsushita Electric Industrial Co., Ltd. and its subsidiaries' ("Matsushita") $6.1 billion dollar acquisition of the common stock of MCA, Inc. ("MCA"). A class action complaint was filed pursuant to section 27 of the Exchange Act (J.A. 81), which confers exclusive jurisdiction of Exchange Act claims on the district courts of the United States. 15 U.S.C. §78aa. The complaint alleged that Matsushita's public tender offer violated federal securities laws because it included (a) a special tax-driven stock swap arrangement that was provided to Lew Wasserman, MCA's chairman and chief executive officer, and (b) a $21,000,000 bonus paid to Sidney Sheinberg, MCA's chief operating officer and owner of 1,170,000 shares (J.A. 85-94). These arrangements were alleged to have violated, *inter alia*, SEC rule 14d-10, the so-called "all-holders, best-price" requirement, because "during [a] tender offer" Matsushita provided higher consideration to Wasserman and Sheinberg and "in a tender offer" also offered consideration not open to all stockholders (J.A. 92-93). Rule 14d-10 prohibits premium payments to favored shareholders as part of a tender offer. 17 C.F.R. §240.14d-10.

The district court dismissed the class action complaint ("Epstein") and an individual complaint ("Minton") (Pet. App. 45a-46a, 60a). In major part, the court of appeals reversed. *Epstein v. MCA, Inc.*, 50 F. 3d 644 (9th Cir. 1995); Pet. App. 1a. On the basis of this court's intervening decision in *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439 (1994), the court did affirm dismissal of the Epstein complaint's "aider and abetter" claims against Wasserman and Sheinberg individually. Pet App.

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filed with the United States Court of Appeals for the Ninth Circuit are designated as "RT [date]."

4a n.7. However, the court held that on the undisputed facts the Matsushita/Wasserman transaction violated 14d-10 (Pet. App. 11a-20a), and that a jury could so find with respect to a $21,000,000 "bonus" received by Sheinberg. Pet. App. 20a-23a.

The court ordered, *inter alia*, certification of a federal class. Pet. App. 43a. The court held that a Delaware settlement that purported to release the 14d-10 class claims did not bar the federal class action, at least where, as here, no material overlap (legally or factually) existed between the state and federal claims. Pet. App. 24a-40a. In view of that holding, the court did not reach several additional arguments demonstrating that the Delaware settlement could not be given preclusive effect. On June 19, 1995, this court granted a writ limited to the issue of the preclusive effect of the Delaware settlement proceeding. J.A. 129.

B. Facts.

1. September 1990 to April 1991. The Delaware actions were commenced on September 26, 1990, when the financial press printed rumors that MCA had agreed to negotiate its sale to Matsushita. Pet. App. 24a. The complaints named MCA (a Delaware corporation) and its directors, including Wasserman and Sheinberg. The gist of the complaints was that MCA's board was not discharging duties owed to its shareholders under Delaware law because MCA had sought no other bids. *No Exchange Act claims were alleged in the complaint, nor of course could they have been, given section 27.* No respondent in this proceeding appeared. Pet. App. 24a; J.A. 261.

On November 30, 1990, the full terms of the MCA-Matsushita deal were disclosed through the required SEC filings, MCA's SEC Schedule 14D-9 and Matsushita's Schedule 14D-1 (D.R. 357, Ex. J; D.R. 13, Ex. A). Shortly thereafter, on December 3, 1990, respondent Epstein, who held one thousand MCA shares (D.R. 429, Ex. C), filed a class action complaint in the United States District Court for the Central District of California. D.R. 1. On December 17, 1990, respondents also moved for summary judgment on the basis of rule 14d-10,

asserting (as the court below was subsequently to hold) that this dispositive issue was a straightforward legal one. D.R. 15 at 6-14; D.R. 16. *Epstein's December 3 complaint was the first time that anyone, anywhere, had made formal legal challenge under federal securities law to the tender offer*, and the first time that petitioners had been named as parties anywhere.

At the time the federal complaint was filed, respondents' counsel ascertained from Delaware counsel that no settlement was in prospect. J.A. 298. Once the federal complaint was filed, however, the state litigation moved very quickly towards resolution. At 3:41 A.M. on December 4th, pursuant to prior agreement, Delaware plaintiffs' counsel faxed a lengthy letter to MCA counsel that purported to summarize the basis for injunctive relief against the merger. J.A. 211. *No mention was made of SEC rule 14d-10.* At a hearing in the district court on December 11, defendants announced a non-opt-out settlement "in principle." RT 12/11/90 at 25-26. The new Delaware complaint was not filed until December 14. J.A. 133. The chronology makes it plain that the complaint was written for settlement purposes only and to obtain as much claim preclusion as possible. For example, the complaint alleged a non-existent state law claim charging that the board had caused MCA to violate rule 14d-10. J.A. 140, 151. Petitioner Matsushita voluntarily accepted the Delaware forum.

The settlement proceeding was held in Delaware on January 30, 1991.[2] J.A. 219. Plaintiffs' counsel stated that he had no evidence to prove the claims in the post-settlement complaint. They were not frivolous, but they would not support a preliminary injunction. J.A. 220-21. *Counsel characterized the federal claims* (which the court had no jurisdiction to adjudicate but which, nonetheless, the Delaware plaintiffs intended to release) *as "frivolous", "... distracting to the main litigation, and ... a*

[2] On December 28, 1990, the district court (Real, C.J.) denied respondents' summary judgment without explanation (RT 12/28/90 at 84).

waste of our time and resources ..." (J.A. 220).[3] Under the proposed settlement the class received no monetary compensation. Delaware counsel, however, were to receive fees up to $1,000,000 *paid for by defendants*. The Delaware chancery court noted that this "generous payment, of course, confers no benefit on members of the [c]lass." *In re MCA Inc. Shareholders Litig.*, 598 A.2d 687, 695 (Del. Ch. 1991) (reprinted at J.A. 170). Rejecting the proposed settlement as an "illusionary" one (J.A. 171), *the vice chancellor characterized the state law claims as "at best, extremely weak."* J.A. 167. They had "little or no value." J.A. 170. He added that "the *only* claims which have any substantial merit *are the claims... in the California federal suit that were not asserted in this Delaware action.*" J.A. 171.

2. **April 1991 to September 1992**. With the settlement rejected, there was no Delaware class action because petitioners had agreed to a class only for settlement purposes.

The *Epstein* litigation continued in earnest. Between April 22, 1991 and the district court's February 1992 grant of summary judgment against respondents, it was intensely litigated. There were, for example, *over three hundred docket entries* in the district court. D.R. 100-416. In Delaware, by contrast, *there were no litigation docket entries* between the April 1991 order rejecting the December settlement and the proposed October 1992 settlement. Pet. App. 26a. In December of 1991, *petitioners' counsel represented to the district court that "[t]he Delaware proceeding is not being prosecuted in any way"* because there "*was no basis for the state law claims.*" J.A. 79. After the district court dismissed the complaint on February 10, 1992 (D.R. 416), respondents appealed to the Ninth Circuit. D.R. 507.

[3] Counsel did not explain why the post-settlement Delaware complaint charged these "frivolous" federal law violations. The obvious inference is that counsel recognized that the other state claims they pled did not encompass the facts and law of rule 14d-10.

3. September 1992 to February 1993. Respondents' filed their brief on the merits in the court of appeals on September 25, 1992.

In October, respondents learned that, in a proceeding "not being prosecuted in any way" and in which no class representatives' appointment had been sought or made, Delaware counsel agreed once again to release the federal rights of third parties. J.A. 172. The federal claims were sold at fire sale prices: two million dollars, a payment of about two to three cents per share from which counsel fees were first to be deducted. J.A. 188 (Stipulation of Settlement, dated Oct. 22, 1992).[4] Petitioners understood full well that only the federal claims had significance. J.A. 79. Delaware law permits large shareholders to negotiate control premiums so long as they do not misuse inside information. Implemented by rule 14d-10, federal law prohibits such a premium in a tender offer. Pet. App. 36a-37a n.31; 50 F.3d at 666 n.31. Petitioners' entire interest was in destroying the possibility that a large federal class action might be certified. For a relatively few dollars, they hoped to have purchased a plenary indulgence absolving them from the substantial classwide consequences of their federal law transgressions.

The October settlement was nevertheless approved. *In re MCA, Inc. Shareholder Litig.*, 1993 WL 43024 (Del. Ch. Feb. 16, 1993) (Pet. App. 63a). The vice chancellor repeated his conclusion that the state law claims were worthless. Pet. App. 68a. Of the federal claims, the vice chancellor said only that they had less value now that the district court had rejected them. *Id.* The vice chancellor conducted *no inquiry* – none – into such crucial questions as whether a class existed, whether the plaintiffs

[4] The notice to class members stated that the settlement included "substantial monetary benefits [to] former MCA shareholders." Pet. App. 94a.

were members thereof, *and most important, whether they and their counsel had provided adequate representation. The vice chancellor acknowledged that the class settlement benefits were "meager" (Id.* at 68a, 72a); *and he stated that "suspicions [of collusion] abound." Id.* at 70a. He concluded that "[s]uspicion . . . is not enough and the objectors have offered no evidence of any collusion." *Id.*[5] He awarded counsel fees in an amount substantially less than had been requested. *Id.* at 70a, 72a.

4. The Ninth Circuit. On February 27, 1995, the Ninth Circuit issued its ruling reversing the district court. After holding that there had been an actionable violation of rule 14d-10, the court addressed the Delaware release. Pet. App. 24a. The court assumed that the Delaware *judgment* ordered the release of the federal claims. Pet. App. 31a. The court further assumed, *arguendo* (but with obvious doubt), that a Delaware judgment could release 1934 Act claims if litigating the state claims would necessarily produce issue preclusion with respect to the central elements of the federal ones. Pet. App. 31a, 33a. Relying, however, upon Judge Friendly's opinion in *Super Spuds*,[6] the court held that 28 U.S.C. §1738 did not require preclusive effect, when, as here, the exclusive federal claims did not overlap (in law or in fact) with any of the compromised state causes of action. Pet. App. 34a. *Petitioners, the court observed, "ma[d]e no attempt to argue that any of the [Exchange] Act claims share any*

[5] The subsequent recital of "adequate representation" in the judgment (J.A. 204) which counsel fashioned and on which petitioners rely is not a "finding", inasmuch as no record evidence of any kind was received in the course of the litigation.

[6] *National Super Spuds Inc. v. New York Mercantile Exchange*, 660 F.2d 9 (2d Cir. 1981). The court in *Grimes v. Vitalink Communications Corp.*, 17 F.3d 1553, 1564 (3d Cir.), *cert. denied*, 115 S.Ct. 480 (1994), made the same distinction, as the Ninth Circuit recognized. Pet. App. 31a-33a.

predicate facts in common with the state law claims that formed the basis of the Delaware class action." Pet. App. 35a.[7] The court's analysis made it unnecessary for it to consider respondents' additional arguments against preclusion grounded in the due process and supremacy clauses.

SUMMARY OF ARGUMENT

Petitioners' argument is not easy to follow. Petitioners never clearly state why the decision below raises a full faith and credit issue, and their various concessions seemingly take that issue entirely out of the case. In the court below, they "expressly disclaim[ed] reliance on claim preclusion." Pet. App. at 34a, n.28. Their brief does not argue that the court below misunderstood their position; or that they are entitled to withdraw their concession; or that they now do argue claim preclusion. In this Court, petitioners reject any analysis grounded on issue preclusion. They fault the opinion below because it "conflates the entirely separate concepts of release and issue preclusion." Pet. Br. at 14. Issue preclusion is irrelevant (Pet. Br. at 22) because, in approving the settlement contract, the Delaware court did not

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[7] On that basis, the court distinguished (Pet. App. 32a-34a) the First Circuit's decision in *Nottingham Partners* and the Third Circuit's in *Grimes*. *Nottingham Partners v. Trans-Lux Corp.*, 925 F.2d 29 (1st Cir. 1991), and *Grimes v. Vitalink Communications Corp.*, *supra*, n.6. As the court noted, these were the only relevant decisions because they alone "implicate the Supremacy Clause, because in each, as here, a state court extinguished exclusively federal claims in settling a state class action." Pet. App. 29a. "In every other case cited by Matsushita, the state court had subject matter jurisdiction to adjudicate all the claims that were released in the class settlement." Pet. App. 30a. In *Nottingham*, it should be noted, the federal plaintiffs had first appeared and litigated vigorously in the state courts the very questions they brought to federal court. 925 F.2d at 30-31, 33. The Third Circuit believed that to be the case in *Grimes*. 17 F.3d at 1562. But see the *amicus* brief by Grimes (pp. 12-14) in this litigation.

"adjudicate" anything. Pet. Br. at 15-16. Petitioners nonetheless insist that the court below disregarded a state court judgment contrary to 28 U.S.C. §1738. Pet. Br. at 25-37. In subsequent litigation, judgments preclude through either claim or issue preclusion. Yet *neither doctrine* is relied upon here. Moreover, petitioners do not argue that a Delaware settlement must be enforced even if the federal claims could not be validly released by contract in Delaware.

Petitioners' avoid conventional analysis under the law of judgments for a reason. From the Delaware decisions petitioners present (Pet. Br. at 25-26), it is clear that the Ninth Circuit (and respondents too) were mistaken in believing that the Delaware *judgment* purported to order the release of the federal claims. Delaware law is otherwise. The release, *not the judgment*, is presented to the federal court; and the Delaware courts state that it is for the federal court to determine the effect and scope of the release. Since the Delaware court's order concerning the federal claims lacks finality, no full faith and credit was denied to the Delaware judgment. The federal court was invited to make its own determination. It did so and properly excluded from the release federal claims that were different in fact and theory from those raised in the state court case. No Delaware judgment was disregarded.

I. Point I demonstrates that the court below correctly considered the exclusive federal claims despite the action taken by the Delaware court. No valid class release could be given as to federal claims having no relation, in fact or law, to the state law claims pled in Delaware. Petitioners seek to avoid this result through a contract analysis. They argue that the class representatives' authority to release Exchange Act claims derives from thousands of individual contracts between the class representatives and class members. The "offer" is the notice of

proposed settlement; the "acceptance" or "consent" occurs when the class member fails to execute an opt-out. Pet. Br. at 21. The law of the state under whose authority they claim the right to contract rejects this claim. In *Prezant v. De Angelis*, 636 A.2d 915, 924 (Del. Supr. 1994), a decision notably absent from petitioners' brief, the Delaware Supreme Court categorically rejected this very consent argument. More fundamentally, the argument misapprehends the nature of class actions. *Class representatives act in a fiduciary manner; they do not make contracts with hundreds or thousands of individual class members*. This Court's cases make plain that class representative's authority to act is derived entirely from a delegation of governmental authority, as *Prezant*, *supra*, 636 A.2d at 923, explicitly acknowledged. If other conditions are also met, a class member's failure to execute an opt-out, when available (compare (b1) and (b2) classes), justifies "presumed consent" to the court's exercising jurisdiction *over the claims asserted in the complaint, not to a bilateral contract with the representative* or the defendant.

Point I also demonstrates that §1738 does not apply here. Delaware law is clear that the release of the federal claims is *not* "incorporated" as an operative, *binding*, part of the state court *judgment*. *Nottingham Partners v. Dana*, 564 A.2d 1089, 1104 (Del. Supr. 1989). To the extent that the release is enforced, it is enforced only as a contract. It is the *release, not the judgment*, that is presented to the federal courts, *ibid.*, and when so presented, the federal court is free to "determin[e] the effect of the release on . . . its own jurisdiction." *Id.* at 1105.

Point I further demonstrates that no Delaware judgment could directly release Exchange Act claims. Section 1738 does not mandate a different result. No decision of this Court holds, or should hold, that a state court judgment can validate, as against absent parties, state court action taken directly in violation of

jurisdictional limitations imposed by an Act of Congress. Finally, Point I addresses petitioners' unfocused "global settlement" policy argument. This Court has repeatedly rejected such arguments when advanced as a basis for ignoring jurisdictional boundaries laid down by Acts of Congress. *See, e.g., Marrese v. American Academy of Orthopaedic Surgeons*, 470 U.S. 373, 385 (1985); *Finley v. United States*, 490 U.S. 545, 555-56 (1989). And the argument is in any event meritless.

II. Point II demonstrates that no judgment could be enforced even if it had purported to order the release of the federal claims. No full faith and credit can be given to a judgment that violates due process. *Kremer v. Chemical Constr. Corp.*, 456 U.S. 461, 480-81 (1982). Lack of adequate representation can be raised by any person when, as here, others seek to bind him by a judgment solely on the basis of representation. *Restatement (Second) of Judgments* §42 (1982). In this case, there was inadequate representation as a matter of law. The vice chancellor held no inquiry under Delaware Chancery rule 23(a). Nothing in the record shows who the state court class representatives are, or that they are members of the class whose claims they purported to release. Moreover, when class counsel announced the proposed settlement, counsel could not litigate the federal claims. Therefore, the entire effort was to disparage them. J.A. 226-39. The vice chancellor, the same vice chancellor reversed in *Prezant*, believed that in a settlement context the only judicial duty was to determine whether or not the settlement made sense from a business point of view. Pet. App. 67a-70a. Adequacy of representation, *vel non*, was irrelevant. Here, as in *Prezant*, he approved the settlement without *any* inquiry into the adequacy of representation despite his own observation that "suspicions [of collusion] abound." Pet. App. 70a. This is an error of a constitutional dimension. Adequacy of representation must exist "at all times," *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 812

(1985); *Prezant*, 636 A.2d at 923, and the class action court must affirmatively satisfy itself of that fact, if the judgment is to bind. *Shutts*, *supra*, at 812; *Prezant*, *supra*, at 924.

III. Point III demonstrates that even if this Delaware judgment ordered the release of the federal claims, the supremacy clause prohibits its enforcement. This Court's decisions establish that a litigant's right of access to the courts of the United States is derived from the Constitution and Acts of Congress. The Delaware proceedings in this case are not an illustration of a good faith "race to judgment" between state and federal courts that is an inescapable feature of "Our Federalism." No good faith litigation was pending in the state courts. Petitioners' counsel represented to the district court that the state court proceeding was not being "prosecuted in any way" because the state law claims were meritless. J.A. 79. Counsel sought to remove an appeal from the Ninth Circuit to Delaware, a "course of conduct designed to insulate the class certification issue from appellate review." *Deposit Guaranty Nat'l Bank v. Roper*, 445 U.S 326, 353 n.12 (1980). Enforcing a judgment whose *only* purpose was to interfere with the jurisdiction of the courts of the United States would violate constitutional principles extending back to *McCulloch v. Maryland*, 17 U.S. (4 Wheat) 316, 426 *et seq.* (1819).

ARGUMENT

POINT I. This Delaware Judgment And Settlement Did Not Purport To, And In Any Event Could Not, Oblige The Federal Court To Enforce This Release

A. The Delaware Judgment Is Irrelevant. Petitioners' argument is not easy to follow. The Ninth Circuit had understood petitioners to assert that the Delaware *judgment* itself adjudicated dismissal of the federal claims. Pet. App. 30a-31a. In that court, petitioners had "expressly disclaime[d] any reliance upon claim preclusion" (Pet. App. 34a n.28), and the court found no issue preclusion with respect to non-overlapping claims. Pet. App. 34a. Here, petitioners apparently contend that the law governing the use of judgments to obtain either issue or claim preclusion is irrelevant (Pet. Br. at 14, 22) because no "adjudication" occurred. Pet. Br. at 15, 17.[8] This Court is invited (Pet. Br. at 15-25) to view a class action settlement as no different from an individual settlement. The class representative has simply made an offer to each class member who has accepted by not opting out. Pet. Br. at 21.[9] After using this contract theory to criticize the court below, petitioners invoke the full faith and credit act, 28 U.S.C. §1738.[10] Pet. Br. at 25-37. They -- quite wrongly -- assert that

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[8] To the extent that the argument assumes that an adjudication is necessary for claim preclusion, the argument is obviously wrong. For example, claim preclusion occurs with respect to claims that could have been but were not raised. *Migra v. Warren City School District*, 465 U.S. 75, 83-85 (1984).

[9] The court below rejected petitioners' argument "that regardless of the 'technical *res judicata* effect' of the Delaware judgment, the *Epstein* plaintiffs are barred . . . as a matter of contract." Pet. App. 37a.

[10] The petition for certiorari asserted that the court below ignored the Delaware judgment (Pet. at 1, 2, 7, 10). Question 1 of the petition asked whether "a federal court can withhold full faith and credit from a *state court*

the settlement and release were "incorporated" into the judgment as a binding part thereof and thus was entitled to enforcement as a judgment.[11] Pet. Br. at 26. Judgments generate either issue or claim preclusion. As we have said, petitioners never explain how the law governing enforcement of judgments can assist them, since they reject any analysis grounded in either issue or claim preclusion.

Petitioners' invocation of the Delaware judgment is directly contrary to Delaware law. A Delaware court's authority to accept a class representative's release of Exchange Act claims rests entirely upon *Nottingham Partners v. Dana*, *supra*, 564 A.2d 1089. There, the court clearly states that the state court's judgment can have a direct operative effect *only on the state law claims*:

> "[T]he law has uniformly distinguished between the approval of a general release and dismissal or adjudication of an exclusively federal claim. The former is within a state court's power, the latter is not." 564 A.2d at 1104.

The *release* (not the judgment) would be presented as a defense in the then-pending federal proceeding. "The defendants . . . may file a motion to dismiss in the federal court *based upon the*

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final judgment approving a class action settlement simply because the settlement released *federal* claims." Pet. at i. The question as it appears in their brief inserts the word "exclusively" before "federal claims." Pet. Br. at i. Their brief also contains numerous references to the Delaware judgment. *See, e.g.*, Pet. Br. at 2, 9-13, 18.

[11] Petitioners' incorporation claim is put in stronger language than they used below. There, they asserted that the scope of the release may not be attacked because it "is a term of the Delaware settlement approved by the Court of Chancery and is explicitly *set out* in that Court's Order and Final judgment." Cir. R. 56 at 26.

release." 564 A.2d at 1104. At that point, the state court acknowledged, *it would be for the federal court to "determin[e] the effect of the release on those claims, in the exercise of its own jurisdiction*." *Id.* at 1105. That was also the vice chancellor's view. In rejecting the first Delaware settlement, he recognized that his judgment had no direct effect on the federal claims. "A federal court is, however, free to review and determine the effect and scope of the release on the federal claims." J.A. 163.[12] This result is fully consistent with a general Delaware practice. A settlement has claim preclusive effect only with respect to claims that could have been pled in the complaint.[13]

Under *Dana*, petitioners' "incorporation" claim is insupportable. The release is enforced with respect to the federal claims in accordance with ordinary contract and agency principles. *Kokkonen v. Guardian Life Ins. Co. of America*, 114 S.Ct. 1673, 1675 (1994), is particularly instructive here. There, this Court clearly distinguished between settlements effective as operative parts of the judgment and settlements to end litigation that are enforced simply as ordinary contracts. Here, under Delaware law,

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[12] The judgment in this case was written by counsel. Pet. App. 72a; Cir. R. 57, Ex. G at Ex. D. It states that the federal claims are compromised "with prejudice by virtue of the proceedings herein and of this order and final judgment." J.A. 206, ¶ 3. Whatever counsels' intention, by Delaware law the judgment merely predicts the federal claims' release, unless issue preclusion occurs because a party has actually litigated an issue in the Delaware court. *Cf. Seagoing Uniform v. Texaco*, 705 F. Supp. 918, 924 (S.D.N.Y. 1989) (counsel may not fashion a Delaware judgment broader than court intended, and thereby secure its expanded effect).

[13] See, for example, *Ezzes v. Ackerman*, 234 A.2d 444, 445-46 (Del. Supr. 1967); *Schlaeppi v. Delaware Trust Co.*, 525 A.2d 562, 565 (Del. Ch. 1986); *Maldonado v. Flynn*, 417 A.2d 378, 383 (Del. Ch. 1980). Nor may Delaware fashion a different rule for Exchange Act claims, for to do so would discriminate against federal claimants. *Howlett v. Rose*, 496 U.S. 356, 383 (1990).

judicial approval was a necessary condition to the existence of the settlement agreement. But the settlement contract's binding quality, when it treats Exchange Act claims, *does not flow from the court's order*.

B. Class Members Do Not Make "Contracts" By Not Opting Out. Petitioners stress the differing judicial roles in adjudication and settlement. In a settlement, they insist, no "adjudication" (a term they nowhere define) occurs. Pet. Br. at 15. Settlements, they insist, are governed by the law of contract. Pet. Br. at 13. But any distinction between preclusion by contract and by adjudication can assist petitioners only if the class representatives had authority to make the contract asserted. Where do they get this authority? Petitioners need a second contract argument, which, although obfuscated, runs like this: The contract offer is contained in the "notice of Proposed Settlement" issued by authority of the Delaware court.[14] Contrary to normal contract law, where silence does not constitute acceptance, failure to execute the representatives' unsolicited opt-out constitutes *individual* consent. Pet. Br. at 21. Petitioners do not say whether the consent is to the settlement agreement or to the putative representatives' "agency."

Petitioners' contract edifice is constructed entirely on this Court's decision in *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797 (1985), which permits nationwide state court damage class actions: "If, as *Shutts* holds, a class member's decision not to opt out constitutes 'consent' to the jurisdiction of the state court, *surely a failure to opt-out of a state court class action settlement likewise constitutes effective consent to the settlement*." Pet. Br. at 21. Petitioners argue that the Ninth Circuit's sharp distinction between

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[14] It should be noted that, as this is a settlement class, when the offer supposedly occurs, no "offeror" has yet been finally appointed as anyone's "representative." *See Prezant v. De Angelis*, 636 A.2d 915, 923 (1994).

individual and class action settlement "simply cannot be reconciled with *Shutts*." *Id.*[15]

Petitioners' argument is deeply misconceived. **First.** The law of the state under whose authority they claim the right to contract rejects their claim. In *Prezant v. De Angelis*, 636 A.2d 915 (Del. Supr. 1994), *the Delaware Supreme Court rejected the very argument petitioners advance*. There, the same vice chancellor as in this case certified a class for settlement only and approved the settlement, but made no finding of adequate representation. He believed the issue to be irrelevant, so long as he was satisfied that the settlement was fair. Those defending the settlement argued for affirmance because, as here, the terms of the settlement were known and a right of opt-out existed. The Delaware Supreme Court rejected the argument. Pointing out that opt-out rights are "infrequently utilized and usually economically impracticable", *id.* at 924, *the court made clear that a class*

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[15] Petitioners now rely entirely on the theory that absent class members make contracts. They distance themselves from what they urged below and on *certiorari*. There, petitioners argued that the state court could accept the release of claims if they concerned the "same transaction." Cir. R. 56 at 13; Pet. at 6. The Ninth Circuit rejected this. Pet. App. 35a-37a. Petitioners apparently now recognize that a "transaction" test simply refocuses attention on the meaning of that term. The state court could not define "transaction" to include directly provisions of the Exchange Act. Moreover, the scope of "transaction" must be approached with restraint in the class action context. *General Telephone Company of Southwest v. Falcon*, 457 U.S. 147, 157-58 (1982). If the issue had been raised there, Delaware would not *define "transaction" to include cases in which no material overlap in fact or law exists between the state and federal claims*. Delaware law of federal claim release requires the existence of the "same operative facts." In *Nottingham Partners v. Dana*, *supra*, 564 A.2d at 1105-06 (Del. Supr. 1989), and in *TBK Partners, Ltd. v. Western Union Corp.*, 675 F.2d 456, 460 (2d Cir. 1982), on which *Nottingham* relied, that standard required that the disputed material element of the settled claim, whether state or federal, was effectively identical to the claim before the court.

member's knowledge of the settlement and his or her failure to opt-out were not the equivalent of consent to anything, especially to inadequate representation. *Id.* at 924. Indeed, the court explicitly rejected the authorities on which petitioners rely. *Id.* at 924 n.6.

Quite plainly, petitioners' theory of the nature of class actions has been jerry-rigged for this case alone. The theory takes no account of the fact that in Delaware most shareholder settlements are certified (as was the first one here (Cir. R. 57, Ex. D)) as rule 23 (b)(2) classes, where no right of opt out exists. No contract theory would remotely explain why these settlements have binding effect. Moreover, petitioners' individual contract argument has no support in ordinary Delaware law governing individual contracts.[16]

Second. Petitioners' argument contains an even more fundamental defect. Class actions are "nontraditional forms of litigation." *United States Parole Commission v. Geraghty*, 445 U.S. 388, 402 (1980). Class actions are assertions of governmental power -- an assertion that depends upon a complex array of judicial findings, including the determination that the representative will adequately represent the class. The representative's authority to bind members comes from the delegation of governmental power, not from contract, as the Ninth Circuit recognized. Pet. App. 37a-40a. "'[C]lass actions involve the delegation of authority [by the state] to pursue a common goal'." *Prezant v. De Angelis*, *supra*, 636 A.2d at 923 (citation omitted). *The class representative is a fiduciary*, not a court appointed "offeror" who enters contracts with hundreds or

[16] To view the obscure notice of settlement as a contract "offer" strains credulity; to view the failure to execute an opt-out as an assent is unprecedented.

thousands of individual members on matters beyond the subject matter jurisdiction of the court.

Shutts supports the decision below, not petitioners' argument. *Shutts* concerned state court *in personam* jurisdiction over absent class plaintiffs. The presumed consent to jurisdiction found in *Shutts* has *no* contractual character as between the representative and the individual class members. The *"consent" is to the authority of the court* over the claims asserted in the complaint.[17] It is a dramatic extension of *Shutts* to argue, as do petitioners (Pet. Br. at 21) that any imputed consent extends to giving the (not yet appointed) class representatives boundless authority to contract away any and all rights of the plaintiff class in any manner related to the transaction, to say nothing of claims within the exclusive jurisdiction of the federal courts. If petitioners' contract theory of *Shutts* were correct, and notice of settlement and right to opt out were all that were necessary, most of rule 23 and its Delaware analogue would be superfluous. But petitioners are not correct. *The fundamental point is that the representatives derive all their authority from the court's*

[17] *Shutts* acknowledged the potential dangers that might lay ahead by virtue of its holding that state court exercise of jurisdiction was reasonable. 472 U.S. at 816-23. It postponed, for example, the question whether a person who did not opt out could be held responsible for costs, or be subject to discovery obligations. *Id.* at 810 n.2. *See* Arthur R. Miller and David Crump, *Jurisdiction and Choice of Law in Multistate Class Actions After Phillips Petroleum Co. v. Shutts*, 96 Yale L.J. 1, 22 (1986).

Shutts also stressed out the importance of notice. In sharp contrast to the practice in this case, letters were sent first class mail, and those that could not be delivered resulted in exclusion from the class. 472 U.S. at 812-13. Here letters were sent to owners of *record*, but *they* (*i.e.*, brokers) were asked to forward the notice to all beneficial owners. As a practical matter, recipients' failure to receive *effective* notice is demonstrated by the fact that *only* 18 chose to opt out. Pet. App. 66a. Compare *Shutts*, where 3,400 opted out. 472 U.S. at 813.

appointment, not from their bilateral relations with class members. A class action is not like an individual action; it is analogous to a "quasi-administrative proceeding, conducted by a judge." *Shutts*, 472 U.S. at 809 (citations omitted); *Prezant v. De Angelis*, 636 A.2d at 922 ("unique character of class actions"). In such a proceeding a class representative is, above all else, *a fiduciary*, not a contract broker negotiating individual contracts with hundreds or thousands of absent class members.

Petitioners' contract argument vests the representatives with a free-standing authority apart from the claims in the complaint. Rule 23(a) (and its Delaware counterpart) shows that this is false. There must be commonality of claims, the representatives' claim must be typical and the representatives must fairly and adequately protect the class interests.[18] As *Prezant* recognizes, these requirements are not matters of contract, and their determination must be made against the allegations of the complaint upon which representative authority is sought. 636 A.2d at 923-24. Unlike individuals and corporations, who do not derive their contractual capacity from the courts, a representative's authority, and in rule 23(b)(3) cases the class' existence as a contracting party, comes from the court. We must, accordingly, look to the class complaint to mark the outer boundaries of authority. In *Local No. 93, Int'l. Assn. of Firefighters v. Cleveland*, 478 U.S. 501, 525 (1986),[19] although noting the contractual aspects of consent decrees, this Court held that "a consent decree must spring from and serve to resolve a dispute

[18] *Shutts, supra*, 472 U.S. at 809-810; *General Telephone Co. of Southwest v. Falcon*, 457 U.S. 147, 156-157, 160-61 (1982); *Nottingham Partners v. Dana*, 564 A.2d at 1094.

[19] "The question is not whether we can label a consent decree as a 'contract' or a 'judgment', for we can do both." *Firefighters, supra*, 478 U.S. at 519.

within the court's subject-matter jurisdiction." And, of course, the court's jurisdiction circumscribes what may appropriately be the subject matter of that complaint.

Distinct Exchange Act claims are not part of the state court complaint. As the vice chancellor said, those claims "were not asserted in this Delaware action." J.A. 171. Petitioners' effort to transcend that limitation by pointing to defendants' "contracts" between the class representatives and the class member has startling consequences. If presumed class consent is not bounded by the complaint, the state court representative should also be able to barter away every right of MCA shareholders, however far removed from the complaint, by sending shareholders a notice of an intention to do so with court approval.[20] Here, for example, the release is drafted so that it "settles" whatever malpractice claims absent class members might have had against Delaware counsel.[21] Pet. App. 93a-94a. Pursuing this logic to its end, Delaware counsel could organize "contract" settlements of federal claims without regard to whether there was any state law litigation in existence. In effect, that happened here. Petitioners revived an abandoned and by counsel's admission non-meritorious state law claim in a moribund state litigation to destroy an intensely litigated federal claim.

Shutts, of course, states the minimum constitutional requirement with respect to state court damage class actions if absent class members are to be bound. Wholly apart from the 14th amendment, however, Congress can impose additional limitations

[20] For example, representatives in a Truth In Lending Act class action protesting inadequate warranty disclosures in car leases could release "any and all claims" arising out of the leases, including all future product liability claims.

[21] Petitioners' argument means that this contract too must be enforced under §1738.

upon the jurisdictional competence of the state court with respect to the enforcement of federal rights. That Congressional authority has been exercised since the First Judiciary Act.[22] *Section 27 is such a limit*. As such, it necessarily limits the authority of any "representatives" with respect to claims under the Exchange Act. *The Delaware representatives are not -- and whatever the intention of the state courts, cannot be made to be -- class representatives insofar as former MCA shareholders' claims under the Exchange Act are concerned*. By virtue of section 27, the Delaware class action is necessarily a *limited* or partial one.[23]

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[22] See P. Bator, *et al.*, Hart & Wechsler's *The Federal Courts and the Federal System* (3rd ed. 1988) at 479 ("Hart & Wechsler").

[23] Limited or partial classes are a common place. Fed. R. Civ. Proc. 23(d); *Manual for Complex Litigation* (Third) §30.46 (1995). This analysis recognizes that a state court might incidentally affect the federal claim because of the issue preclusive effects of its findings on matters admittedly within its jurisdictional competence. *Becher v. Contoure Laboratories, Inc.*, 279 U.S. 388 (1929), is a good example. The state court ruled that the defendant patent holder had appropriated his invention from the plaintiff. This finding established the patent's invalidity if the patent holder subsequently sued in federal court to enforce it. This Court distinguished between "establishing a fact" which was within the power of a state court in a prior proceeding, and "giving a specific effect to [that fact]", which was a power reserved to the federal court by virtue of the grant to it of exclusive jurisdiction. *Id.* at 391. Relying on *Becher*, Judge Hand made a similar distinction in the antitrust context, but he strongly suggested that exclusive jurisdiction grants required the federal court itself to redetermine any broader state court conclusion. *Lyons v. Westinghouse Electric Corp.*, 222 F.2d 184, 189 (2d Cir.), *cert. denied*, 350 U.S. 825 (1955). Petitioners, we note, make no effort to extend these conventional cases by arguing that the state representatives should be able to release what their litigation would necessarily bar through issue preclusion. This is because the argument could not help them given the Ninth Circuit's no overlap holding. Moreover, here the destruction of the federal claim was not "incidental" to otherwise valid state proceedings, but the entire purpose of those proceedings. Until *Marrese v. American Academy of Orthopaedic Surgeons*, 470 U.S. 373 (1985), the cases and debate focused on whether *federal* preclusion law should give effect to state court determinations on matters other than fact. See, *e.g.*, Comment, 8 Stan. L. Rev. 439 (1956); Note, 69 Yale L.J. 606 (1960); Note, 46 NYU L. Rev. 936 (1971).

Seemingly, petitioners concede this point. They do not and cannot assert that "acting pursuant to Delaware class action law" (Pet. Br. at 21), or general state contract law, the representatives could be authorized by the court or their class members to *litigate* an Exchange Act claim. Petitioners never explain why, in these circumstances, a state court can grant class representatives authority to release Exchange Act claims that are beyond the court's subject matter jurisdiction. Differences between adjudication and settlements have absolutely no explanatory power.[24] "The logical question", wrote Judge Easterbrook, "is whether the person making a contractual undertaking to settle a case has authority to enter the contract . . . if he does not, it does not gain any additional force by being filed with a court." Frank H. Easterbrook, *Justice and Contract in Consent Judgments*, 1987 U of Chi. Legal Forum 19, 35 (1987). Judge Easterbrook added, "[u]ltimately there is no good reason to allow consent decrees to make binding promises that exceed the authority parties would have in the absence of litigation." *Id.* at 39.

If there is *no* material overlap between a release and what is alleged in the class complaint -- and the court below said this is true (Pet. App. 34a, 35a) without challenge by petitioners (pp. 7-8,

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[24] Suppose, for example, that, as is the usual practice, the class representative was appointed *prior* to settlement. Would the class notice be a valid exercise of state power if it said that the representative's authority includes the right to litigate federal claims in the state court? To compromise them? Does it toll the federal statute of limitations? The state court could not confer such authority. That judicial approval of such a representative's conduct was granted *ex post* in a class certified for settlement only does not change the underlying legal issue.

supra)[25] -- how could that release fall within any conceivable conception of a class representative's authority? Both the due process clause and the basic structure of our federal union of states circumscribe any possible assertion of state authority here. See *Shutts*, *supra*, 472 U.S. at 818-19 (state cannot apply its own substantive law unless it has sufficient contact with person or transaction). Equally compelling, here there is an Act of Congress. By virtue of § 27, Exchange Act suits are not within the subject matter jurisdiction of the state court.

Given the large percentage of settlements in all litigation, including securities litigation, petitioners' "contract" analysis effectively eviscerates § 27's direction that Exchange Act litigation is not to proceed in the state courts.[26] Yet, they insist that this

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[25] The same is true in their petition for *certiorari*. In their opening brief, however, petitioners seek to withdraw from their no-overlap concessions by objecting that the Ninth Circuit's test is "unadministratable." Pet. Br. at 43-45. This move is unavailing here. Whether issue preclusion has resulted from a prior suit is a familiar issue for courts. *Restatement (Second) of Judgments* § 27 (1982). Moreover, presumably this court did not grant certiorari to review the determination that there was no overlap. And, in fact, there would be no issue preclusion under traditional principles, given the issues before the Delaware court, a fact that petitioners seek to obscure. See p. 17, n.15, *supra*. Finally, whether a Delaware *settlement* (rather than an adjudication) could work issue (rather than claim) preclusion against third persons solely on the basis of representation raises issues of due process not briefed here, and beyond the scope of the writ in this case.

[26] Petitioners' argument (Pet. Br. at 19-21) that the exclusive jurisdiction is riddled with exceptions is wrong in fact (and irrelevant were it true). 1934 Act claims may be arbitrated, but that is pursuant to another Act of Congress and the arbitration rules are SEC supervised and the awards are federally enforced. *Shearson v. McMahon*, 482 U.S. 220 (1987). Of course, individuals and corporations can settle such disputes; they can also make contracts without coming to court. The states can adjudicate 1934 Act claims if they provide a federal defense to state-created liability; the states may not, however, adjudicate them as counterclaims. *Western Capital Securities v. Knudsvig*, 768 P.2d 989, 992-93 (Utah App. 1989). The issue

does not matter because § 27 is concerned only with (their undefined term) "adjudication" (Pet. Br. at 15, 21), not "contracts." This distinction finds no place in the language of § 27, which denies state jurisdiction over suits "*to enforce* any liability or duty" created by the act and its regulations.[27] Petitioners' "settlement" surely falls within that language. The state law claims were both meritless and abandoned. All that was being "enforced" in the state court is the Delaware representatives' (two cents-a-share) valuation of the federal claims asserted in the *Epstein* litigation. This is the exercise of power conferred exclusively on the federal courts under § 27 (p. 47, *infra*).

C. The Irrelevance of Section 1738 To This Litigation. After having stressed the limited *judicial* role in "contract" settlement, petitioners invoke (Pet. Br. at 25-37) "the full faith and credit" statute, 28 U.S.C. §1738. Petitioners make no claim that the *judgment* extinguishes the 14d-10 claims other than by incorporating the settlement. Under *Nottingham Partners v. Dana*, *supra*, and the vice chancellor's first opinion in this case, no "incorporation" can reach the release of federal claims, because

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preclusive effects of state court *findings* rests on the fact that the matter has been subject to full *judicial* determination, not a one-judge-business-judgment review. And there is nothing anomalous in the state courts' different authority over 1933 and 1934 Act claims. Congress made that choice. Even if originally enacted without discussion, Congress' current concern to enact legislation creating a fair balance in federal litigation of 10b-5 claims shows that the exclusive jurisdiction is still desired.

[27] After *Osborne v. Bank of the United States*, 22 U.S. (9 Wheat) 738 (1824), it "would be universally conceded that a further constitutional function of federal courts is to enforce federal law -- to establish the facts determinative of the application of federal law even if the law's content and applicability are undisputed, and to enter and enforce the appropriate judgment." Hart and Wechsler, *supra*, at 984.

that was for the federal court to determine "in the exercise of its own jurisdiction." 564 A.2d at 1105. Since the Delaware order concerning the federal claims lacks finality, no full faith and credit was denied to the Delaware judgment. Moreover, petitioners nowhere explain how their "incorporation" theory could transcend the limits of *both* state (*Dana*) and federal (§ 27) law.

There is another reason why §1738 is irrelevant. *Petitioners have never argued that §1738 protects a Delaware judgment if, because of section 27, the Delaware courts lack authority to authorize class representatives to release the federal claim.*

D. Section 1738. The question presented in the petition asserts (incorrectly, as we have shown) that the state court judgment directly released the federal rights. Even if that were true, §1738 would not require that preclusive effect be given to the judgment.

1. Delaware. When petitioners present a Delaware judgment as a defense in a federal proceeding, they must, as a threshold matter, show that the Delaware courts would invoke it to bar this action in Delaware. Petitioners make no such showing. The vice chancellor's intent to authorize the representatives to release the 14d-10 federal claims does not immunize the judgment from collateral attack. Petitioners concede that *no one* challenged the vice chancellor's subject matter jurisdiction. Pet. Br. at 8. Delaware courts would permit respondents to raise the jurisdictional objection that *Dana's* analysis does not apply to completely distinct claims, and could not constitutionally do so.[28]

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[28] *Division of Child Support Enforcement v. Myrks*, 606 A.2d 748 (Del. Supr. 1992); *Brooks v. Taylor*, 154 A.2d 386 (Del. Supr. 1959); *Epstein v. Chatham Park, Inc.*, 153 A.2d 180 (Del. Supr. 1959) (original court must have jurisdiction).

Moreover, even if the Delaware courts might enforce the contract, the Delaware Supreme Court in *Dana* did not believe that the federal courts were under a similar compulsion. 564 A.2d at 1105.

2. Section 27. This Court has never authoritatively resolved the relationship between §1738 and Congressional statutes conferring exclusive jurisdiction upon the courts of the United States. *Marrese v. American Academy of Orthopaedic Surgeons*, 470 U.S. 373 (1985), the *only* decision on point, makes that clear. There, the court of appeals had applied a federal common law rule of preclusion that was *broader* than that contained in most states' laws. This Court directed the court to determine, so far as possible, the content of state preclusion law, 470 U.S. at 380-83, stating that this disposition made unnecessary resolution of "the more general question . . . whether the concerns underlying a particular grant of jurisdiction justify a finding of an *implied partial repeal* of §1738."[29] *Id.* at 386. *Marrese* framed the inquiry in terms of "implied partial repeal" -- in order to effectuate "the intent of Congress."[30] Prior to 1982, however, there was no understanding that §1738 was applicable, *when the subject matter*

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[29] *Marrese* "leaves unexplored the difficult question whether and when state preclusion rules can be defeated by the policies that led Congress to make federal jurisdiction over a certain class of claims exclusive." Hart and Wechsler, *supra*, at 1628.

[30] *In so doing, Marrese* endorsed a rationale that, in fact, *Kremer* had asserted without analysis in *Kremer v. Chemical Construction Corp.*, 456 U.S. 461, 468 (1982). Moreover, *Kremer* itself came but a year after this Court had said that §1738 did not apply if the state court "did not have jurisdiction over the subject matter or the relevant parties." *Underwriters Nat'l Assurance Co. v. North Carolina Life and Accidental Health Ins. Gty. Ass'n.*, 455 U.S. 691, 704-705 (1982) ("*Underwriters*").

limitation on the state court was the result of an act of Congress.[31] The applicable rules of preclusion were drawn from federal common law. *See University of Tennessee v. Elliott*, 478 U.S. 788, 794 (1986) (court has "fashioned federal common law rules of preclusion in absence of a governing statute").[32]

If "the intent of "Congress" is crucial, Congress, in enacting §1738, could not have intended an assault on its own statutes that excluded the states from exercising jurisdiction.[33] No

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[31] That premise reflected the legal landscapes against which both §1738 (1790) and the Exchange Act (1934) were enacted. "The [1790] Act extended the rule of the Constitution to all courts, Federal as well as State." *Davis v. Davis*, 305 U.S. 32, 40 (1938). When §1738 was enacted, exclusive jurisdiction provisions were *already* in existence. Their purpose was not simply to confer jurisdiction, but to keep the state courts out. Exclusive jurisdiction means, in the language of the First Judiciary Act, "jurisdiction exclusive of the state courts." It is awkward to see these provisions as now subject to an "implied partial repeal" analyses, because those who enacted them "knew" that §1738 did not affect them. For this Court's practice, see *Lessee of Hickey v. Stewart*, 44 U.S. 750, 762 (1845); *Oliver v. Rumford Chemical Works*, 109 U.S. 75 (1883) (*dictum*, disregarding state decree). We know of no early federal case that suggested that §1738 limits federal power over claims within exclusive federal jurisdiction. The absense of such decisions strongly reinforces the position that §1738 has no applicability in these circumstances.

[32] Until *Allen v. McCurry*, 449 U.S. 90 (1980), focused attention on §1738, the courts thought in terms of "general" rules of preclusion in exclusive jurisdiction cases. And a significant consensus emerged. And, it should be noted, this consensus emerged unsympathetic to the federal plaintiff who had lost in the state court and recast the same factual allegations as federal claims. Many courts and commentators objected to this "two bites at the apple approach." Still, the courts assumed that the issue was a matter of federal common law. *E.g.*, *Abramson v. Pennwood Inv. Corp.*, 392 F.2d 759, 762 (2d Cir. 1968).

[33] The Court need not hold that § 27 impliedly repeals §1738. There is no language of §1738 that the court must disavow to permit this suit to go forward. Rather, here as in *United States v. Fausto*, 484 U.S. 439 (1988),

decision of this Court suggests, even in *dicta*, that a state court judgment can validate, as against absent parties sought to be bound only on the basis of representation, state court actions that directly violate Congressionally imposed subject matter limitations.[34] If

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the issue is the extent to which one federal statute, §1738, must be read in light of, and may be altered by, the implications of a later-enacted federal statute so as to get them "to 'make sense' in combination." *Id.* at 453. This is the approach that this Court followed in *Shearson v. McMahon*, 482 U.S. 220 (1987), where it held that § 27 did not displace another federal statute with respect to arbitration of individual claims.

[34] *Marrese* held that a federal court may not give preclusive effect to a state court judgment under §1738 without *first* determining whether state law would require such preclusion. The decision had strong federalism overtones. The plurality in the court below had held that as a matter of federal common law (not §1738) the prior state proceeding had precluded a subsequent federal antitrust suit. Three state attorneys general argued against broad preclusion rules because local lawyers unfamiliar with federal law would harm their clients. Thus *Marrese* protected states against federal imposition of expansive preclusion rules. The case does not hold that a federal court *must* give preclusive effect under §1738 to a state court judgment that violates the explicit limitations on state court jurisdiction prescribed by federal statute. As the court said, "[u]nless application of Illinois preclusion law suggests, contrary to the usual view, that petitioners' federal antitrust claim is somehow barred, there will be no need to decide in this case if there is an exception to §1738." *Marrese*, 470 U.S. at 383. However broad or narrow those exceptions may be, one thing must be clear; it would defeat the purpose of exclusive jurisdiction if a state court could simply violate § 27 and then use §1738 to defeat the right of the federal court to hear the case at all -- in effect, requiring the federal court to enforce the state court's violation of federal law.

Kremer is even more removed from this case because the Congressional legislation plainly contemplated an affirmative role for state enforcement mechanisms. In *Kremer*, the court held that under §1738 a state court employment discrimination proceeding could preclude a federal Title VII claim, because neither "the language [n]or operation" of Title VII disclosed a "manifest incompatibility between Title VII and §1738." 456 U.S. at 470. Title VII, however, clearly contemplated some role for state proceedings in the administration of the federal remedy. Title VII affirmatively required plaintiffs to exhaust state administrative remedies by

§1738 is given any direct role in such cases, no formulation of the applicable rule should impel this Court to frame the central issue in all or nothing terms -- § 27 is, *e.g.*, either entirely outside §1738, or it is not.

Petitioners denigrate § 27 as a Congressional mistake, implicitly inviting the court to view "implied partial repeal" as an all-or-nothing proposition (Pet. Br. at 32-33). In considering § 27's impact on §1738, it is important to bear in mind that federal and state securities laws often contain important substantive differences, as this case illustrates. When federal law imposes duties that have no state law counterpart, indeed when, as here, federal law is designed to *reject* state law (*Polaroid Corp. v. Disney*, 862 F.2d 987, 992 (3d Cir. 1988), there is no reason whatsoever to allow states by adjudication or by contract to undercut the federal mandate. Moreover, even when an overlap exists between state and federal law, as is typically the case in 10b-5 cases, the extent of the overlap is easily exaggerated.[35] In

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filing charges with the appropriate state agency (if one existed) before commencing federal proceedings. 42 U.S.C. §2000e-5(c). The statute said nothing to indicate that the States were forbidden from providing judicial review for such state-agency proceedings, as was typical of administrative procedure. In those circumstances, it can scarcely be thought that a "manifest incompatibility" existed between Title VII and an interpretation of §1738 that gave preclusive effect to judicially reviewed administrative findings. In contrast, where a statute, like the Exchange Act, explicitly ousts state courts from any jurisdiction over a class of claims -- that is, where Congress has created a right to a federal forum -- it is equally difficult to maintain that there is no "manifest incompatibility" between the "operation" of § 27 and a construction of §1738 that effectively makes binding upon federal courts a state court's violation of § 27's exclusivity requirement.

[35] 10b-5 claims differ significantly from state fraud claims in many respects. For example, no state analog exists to the presumption of market reliance recognized by this court in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

addition, both *Kremer and Marrese* involved state court adjudications. For purposes of §1738, it is not evident that their principle applies to settlements, especially to classes certified *only* for settlement purposes. In a settlement a judge applies only a "business judgment" standard (Pet. Br. at 35 n.35); adjudication, however, brings focused judicial attention on explicit facts or legal issues, and a right to appeal within the state that further sharpens the issues. There is, accordingly, less danger that federal law interests will be overlooked. Petitioners' argument that "no federal interest is implicated when a state court approves a release of a federal claims" (Pet. Br. at 35 n.29) gets matters backwards. Finally, different state and federal remedial frameworks may exist. For example, in Delaware, no class action for damages can be maintained for fraud. *Prezant v. De Angelis*, *supra*, 636 A.2d at 920. This means that class counsel must frame their claims as equitable ones, and cannot get the benefits of a jury trial.

E. § 27 Is Fully Applicable to Settlements. Laid bare, petitioners invite this Court to ignore settled limitations on state court competence by invoking some supposed policy favoring "global" settlements (Pet. Br. at 46-47, 49). Petitioners never identify the source of their "global" settlement policy (state or federal law) or its content. They never explain why when state and federal claims do not overlap there is any *improper* inhibition of any state court settlement process. They never mention the existence of the legislation that, at this writing, has passed both Houses of Congress and that is directed to abuses in class action securities settlements. The proposed legislative revision of class action procedures for 1934 Act cases is certainly not premised on the belief that the same class action abuses can continue by "releasing" 10b-5 claims in state court.[36] Congress wants reform,

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[36] The proposed federal legislation presumptively gives control of the class action to larger shareholders. The legislation would prohibit just the

not abolition of Exchange Act class actions. More fundamentally, petitioners ignore that a similar "efficiency", "one-law suit" argument was directly rejected by this Court in *Marrese* as a justification for disregarding rules imposed by Acts of Congress defining the appropriate allocation of functions between state and federal courts. 470 U.S. at 385. *See also Finley v. United States*, 490 U.S. 545, 555-56 (1989). Efficient or not, Congressionally imposed jurisdictional limitations must be respected. If Congress wishes to alter the jurisdictional limit it can act, as it did after *Finley*. See 28 U.S.C. 1367.[37]

Petitioners' claims, if sustained, are bound to generate unseemly judge -- or, more accurately, lawyer -- shopping by defendants seeking the cheapest settler. *Prezant v. De Angelis*, *supra*, 636 A.2d at 919. They portend other difficulties as well. Delaware shareholder settlements are generally fashioned on a non-opt basis. If the presence of damages claims does *not* constitutionally compel the opportunity to opt-out, an issue left open by this Court in *Ticor Title Ins. Co. v. Brown*, 114 S.Ct. 1359 (1994), then as a practical matter the Delaware court (and any other state court) will be able to control the operation and effect of the securities laws by the technique of settlement. The exclusive jurisdiction conferred by Congress on the federal courts

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kind of false assertions of "substantial benefits" that the settlement notice in this case made. The legislation requires that the class be given detailed information before any settlement. To permit state plaintiffs who do not meet federal standards to settle 1934 Act claims will eviscerate the legislation's protective function. H.R. 1058, 104th Congress, 1st Session (1995); S.240, 104th Congress, 1st Session (1995).

[37] Petitioners implicitly argue that there must be only one court if there is to be a global settlement. This is wrong. Partial settlements are a common place in class actions. *Manual for Complex Litigation (Third)* §30.46 (1995). Moreover, it is far from uncommon for "settlers" to present a complaint settlement for the approval of both a federal court and an administrative agency, and for a state and federal court.

will instead be transferred to the state courts. This, in turn, would restrict this Court's appellate jurisdiction because only a contract is involved.

Finally, petitioners make absolutely no mention of the dangers to the enforcement of the securities law created by the newly claimed authority of the Delaware courts. Professor Coffee describes this as "the most interesting recent development in securities litigation."[38] "[W]eak derivative and class action claims that once would have been routinely dismissed by the Delaware Chancery Court now have an enhanced settlement value, . . . because they can release federal claims." J.A. 276. In language especially apt here, he notes that "ironically the incentives for defendants are . . . never [to] seek dismissal on the merits of a state class action if a companion federal class action raising related federal claims is possible, but instead reach a settlement in which the defendants are given a general release."[39] J.A. 276. Those dangers are greatly intensified when, as here, the class has been certified for settlement purposes only.

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[38] John C. Coffee, Jr., *Suspect Settlements in Securities Litigation*, N.Y.L.J., March 28, 1991, at 5 col. 1 (J.A. 275).

[39] *See also, e.g.*, Anthony Borden, *The Shareholder Suit Charade: The Wilmington Filers Shake Down Corporations in Delaware, and No One Seems To Mind*, Am. Lawyer at 67 (Dec. 1989); *Coupon Clipping For Lawyers*, editorial, Wall Street Journal, November 18, 1993, A20, col. 1; *Millions for Us, Pennies for You*, N.Y. Times, Dec. 19, 1993, Section 3, p. 1. The subheading read, "Suits on behalf of investors enrich lawyers. But what of their clients?"

POINT II. This Delaware Settlement Release Proceeding Violated Due Process.

For the reasons discussed in Points I and III, respondents believe that they were not required to expose their federal class action claims, already on appeal, to a state court settlement proceeding. Even if they are wrong on these points, no court could enforce *this* release against absent class members (even had its terms been judicially ordered) because the result would violate due process. "A State may not grant preclusive effect in its own courts to a constitutionally infirm judgment." *Kremer v. Chemical Constr. Corp.*, 456 U.S. 461, 482 (1982).[40] Adequacy of representation is, of course, open to challenge by any litigant who did not make a personal appearance and who is sought to be bound by representation alone. "[A]fter judgment has been entered and subsequently is invoked against the class, the adequacy of representation is open to examination . . . [and] doubts over the adequacy of representation are more readily resolved in the direction of withholding *res judicata* effects of the judgment." F. James, G. Hazard, and J. Leubsdorf, *Civil Procedure* 631 (1992) ("James and Hazard") (citing Restatement (Second) of Judgments §42, comments e and f). This is familiar law.[41]

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[40] The full faith and credit requirement "is necessarily to be interpreted in connection with other provisions of the Constitution, and therefore no state can obtain in the tribunals of other jurisdictions full faith and credit for its judicial proceedings if they are wanting in the due process of law enjoined by the fundamental law." *Old Wayne Mut. Life Ass'n v. McDonough*, 204 U.S. 8, 15 (1907).

[41] *Hansberry v. Lee*, 311 U.S. 32, 41-43 (1940), made plain that the constitutional sufficiency of adequate representation is open to collateral attack by absent class members. The court cited §1738, *id.* at 40, but found it no bar. Class actions are no exception to the rule "that the court conducting the action cannot predetermine the *res judicata* effect of the judgment . . . [and] due process of law would be violated for the class judgment unless the court applying *res judicata* could conclude that the class

Compliance with due process is a necessary part of any full faith and credit inquiry, and while the court below did not rest its decision on due process grounds, they were strongly argued and they fully support the judgment. *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 279 (1976). In significant respects, moreover, they provide an alternative formulation of the holding below.[42] Additionally, they raise important issues in the administration of class actions. Few contemporary issues are as troublesome as the marriage of class action and settlement releases. The issues are especially worrisome when, as here, a class is certified only for settlement purposes. *See Prezant v. De Angelis*, *supra*, 636 A.2d at 921-25, and *In re General Motors Pick-Up Truck Fuel Tanks Prod. Liab. Litig.*, 55 F. 3d 768, 794 (3rd Cir. 1995) ("General Motors").

In state class actions organized under analogues to rule 23(b)(3) the state court has no *in personam* jurisdiction to bind absent class members unless the due process criteria *Shutts* sets out are met. This settlement proceeding fell far short of those requirements. No class action release can bind absent class members unless a judicial inquiry determines, on the record, that a class exists and that it has or will be adequately represented by

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was adequately represented in the first suit." 3 Newberg and Conte, *Newberg on Class Actions*, §16.25 at pp. 16-133-137 (3d ed. 1992) (collecting authorities from virtually every circuit). Petitioners' unexplained invocation of the "Rooker-Feldman" doctrine (Pet. Br. at 35 n.29) is meritless. See *Homola v. McNamara*, 59 F.3d 647, 649 (7th Cir. 1995) (Easterbrook, J.)

[42] A state representative has no bargaining leverage with respect to claims he or she cannot litigate, even in the guise of asserting partly parallel state claims. Such a representative is necessarily an inadequate representative. That due process objection captures the Ninth Circuit's concern that the material elements of the 14d-10 claim were totally different from those that Delaware counsel could litigate. Pet. App. 35a-37a.

named plaintiffs and their counsel. No such inquiry was held.[43] Moreover, this record as it now stands discloses *as a matter of law* both inadequate class representation and inadequate judicial supervision of the settlement proceeding.

A. Inadequate Representation. The relevant principles governing adequacy of representation are familiar ones, and we will not burden the court with endless citations to the extensive authorities.[44] Suffice it to say that the class representative must have a commonality of interest with the class, have no disabling conflict of interests, and fairly and vigorously represent the class members. *Shutts*, *supra*, 472 U.S. at 808-810; *Restatement (Second) of Judgments* §42 (d) and (e). We turn now to the relevant facts.

1. Class Representatives. *Who are the class representatives*? Nothing in the record shows that the class representatives were members of the state court class, or if so, that they were among the smaller group that held the Exchange Act claims they tried to release.[45] In fact, not even the plaintiffs'

[43] "[We] do not believe that a class action settlement can constitutionally bind absent class members without a judicial determination [of] . . . adequate representation. *Prezant*, *supra*, 636 A.2d at 924.

[44] For a collection of the cases, see, for example, 5 Newberg and Conte, *supra*, at §§22.26 *et seq.*; 7A C. Wright, A. Miller, and M. Kane, *Federal Practice and Procedure*, §§1765-69.1 (1986) ("Wright and Miller"). These principles are, of course, fully applicable to the settlement context. Id. *at* §§1791 and 1797. 2 Newberg and Conte, *supra*, at ch. 11, collects the authorities on class action settlement.

[45] The complaint simply states that plaintiffs are MCA shareholders. J.A. 136, ¶ 7. There is no allegation, to say nothing of a finding on the record, that plaintiffs continued to hold their shares and tendered them, rather than selling them before December 31 or taking cash in the short form merger that followed the tender offer. Only those who tendered have Exchange Act claims. Pet. App. 11a & n.16; J.A. 83, 99.

names appear in the settlement complaint. J.A. 133. In *Prezant*, *supra*, 636 A.2d at 925-26, the Delaware Supreme Court rejected a settlement because the record did not contain a finding of adequate representation. Here, after his own opinion noted "suspicions" of "collusion", the Delaware vice chancellor subsequently signed a formal order prepared by counsel reciting the existence of "adequate representation." J.A. 204-205. That "finding" is not the product of an inquiry as both *Prezant* and *Shutts*, 472 U.S. at 809, require, if absent parties are to be bound. *Prezant* makes plain that such a finding is not a matter of form and that a baseless finding is not sufficient. 636 A.2d at 924-25. Findings "on the record" are required. *Id.* The court disapproved any chancery practice to the contrary. *Id.* at 925. It stated that "[t]he court may make such a finding on the basis of a record containing sworn testimony, by affidavit and/or deposition." *Id.* Satisfaction of this requirement, "*in every class action*", the court noted, is necessary if "[d]efendants [are to be] protected from a possible collateral attack. . . ." (*Ibid.*).[46] (Emphasis in original.)

The chronology, however, reveals one important fact about the class plaintiffs. When their counsel sought class certification, *plaintiffs had no federal claims that they could assert*. Their federal claims could be litigated only if *respondents* prevailed on appeal. Otherwise, Delaware plaintiffs were barred by the statute

[46] Petitioners' unsupported claim that adequacy of representation was "litigated and decided" (Pet. Br. at 23) in Delaware is false, and in any event would not bind absent class members. Interestingly, the class settlement stipulation contained a proposed order that did not include even a finding of adequate representation. Cir. R. 57, Ex. G at Ex. D. Only after approving the settlement was the vice chancellor provided with an order reciting such a finding. J.A. 204-205. The Vice Chancellor did not think that issue in any way material, and his opinion says nothing favorable to adequacy. *See* p. 43, *infra*.

of limitations.[47] What is more, even if the plaintiffs could have asserted individual claims, any class action would be barred by limitations.[48] Surely, inadequate representation exists as a matter of law when a class representative releases claims that he or she has no power to assert in any court.[49]

2. Class Counsel. In fact, of course, the Delaware plaintiffs' *lawyers* were the only "representatives" of whom the Delaware court took heed, and, even then, only through argument, and not sworn testimony or affidavit.

(a) Inherent Conflict of Interest. A person is not bound by a representative where "there was a substantial divergence of interest between him and the members of the class . . ." *Restatement (Second) of Judgments*, *supra*, §42(d).

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[47] *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991) states that 1934 Act claims must be brought within one year of discovery. Under *American Pipe and Constr. Co. v. Utah*, 414 U.S. 538 (1974) and *Crown, Cork & Seal Co. v. Parker*, 462 U.S. 345 (1983), the statute is tolled once the complaint is filed unless the district court denies certification. The court did so in April of 1991 and again on September 6, 1991. D.R. 98, 173. When the settlement was announced in October 1992, the statute had run even if September 6, the second *Epstein* certification denial, is viewed as the trigger date. *Davis v. Bethlehem Steel Corp.*, 769 F.2d 210 (4th Cir.), *cert. denied*, 474 U.S. 1021 (1985).

[48] Tolling does not extend to new class action claims. See *Andrews v. Orr*, 851 F.2d 146, 149 (6th Cir. 1988): "[T]he courts of appeals that have dealt with the issue appear to be in unanimous agreement that the pendency of a previously filed class action does not toll the limitations period for additional class actions by putative members of the original asserted class." See *Korwek v. Hunt*, 827 F.2d 874, 879 (2d Cir. 1987); *Salazar-Calderon v. Presidio Valley Farmers Ass'n.*, 765 F.2d 1334, 1351 (5th Cir. 1985), *cert. denied*, 475 U.S. 1035 (1986); *Robbin v. Fluor Corp.*, 835 F.2d 213, 214 (9th Cir. 1987).

[49] Such a representative does not meet the requirements of *General Telephone Co. of Southwest v. Falcon*, 457 U.S. 147, 156 (1982); *Shutts*, *supra*, 472 U.S. at 809-810.

When in October of 1992 they applied to act as class counsel their clients had no federal rights they could assert. *Delaware counsel had every incentive to compromise substantial federal claims*. The state claims, they had previously been authoritatively told, were worthless, and they had in fact been abandoned. J.A. 159, 167. Counsel had also previously denigrated the federal claims, and in any event could not litigate them. The result: If they settled the federal claim, counsel would get paid; if they litigated, they would get nothing. Such a one-sided incentive structure is surely a constitutionally disabling conflict of interest for class counsel who stand in a fiduciary relationship to the class.[50] *Cf. Tumey v. Ohio*, 273 U.S. 510, 523 (1927). See *Zarowitz v. BankAmerica Corporation*, 866 F.2d 1164, 1166 (9th Cir. 1989). Put another way, a class settlement violates due process when, as here, the class is created for settlement purposes only and the settlement is intended to have preclusive effect on pending litigation with respect to federal claims that class counsel -- as petitioners fully realized -- has no intention or ability to prosecute.[51]

(b) Counsels' Conduct. Counsels' conduct fell below the minimum standards required for adequate representation under the due process clause. Counsel made no effort whatsoever to determine the basis of respondents' belief that they would prevail in the Ninth Circuit, whether there were settlement negotiations, or the status of the extensive discovery in federal

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[50] "The class action remains . . . a very troublesome procedure. A chief problem is protecting the class members not only [from the representative] but also from the more serious possibility that the class lawyer (also usually self appointed) has interests that conflict with those of the other clients." James and Hazard, *supra*, at 564.

[51] "When competition among different sets of plaintiffs' counsel exists, as it does here, there is the ever present danger that unscrupulous counsel may 'sell out' the class in order to receive a fee." *Prezant v. De Angelis*, *supra*, 636 A.2d at 922. See also *General Motors*, *supra*, 55 F.3d at 801-804 (reviewing the authorities).

court. Instead, counsel simply filed a memorandum of law supporting the October settlement. J.A. 289. Their entire focus was how unlikely it was that respondents would win their appeal in a manner that benefitted the class.[52] Cir. R. 57, Ex. N.

The memorandum did not present the issues in the federal appeal in a manner consistent with what the Constitution demands if the rights of absent class members are to be compromised. For example, the memorandum (J.A. 293-95) explained how unlikely it was that the Ninth Circuit would find a private right of action without mentioning that the Second and Third Circuit opinions authored by Judges Winter and Becker had already found such a right (Pet. App. 11a), or that the district court's conclusions of law (which were drafted by petitioners) had acknowledged such a right. Pet. App. 52a-53a. Nor did counsel mention that petitioners had conceded the existence of such a right of action in their brief on appeal. Pet. App. 5a n.9.

Counsels' presentation of the class action aspects of the federal litigation was similarly marred. The claim that Wasserman received a higher consideration contrary to rule 14d-10 alleged a class action indistinguishable from the hundreds of securities fraud actions. (The Ninth Circuit held that it "fits . . . like a glove." Pet. App. 40a-41a.) Asserting that reversal was unlikely, the memorandum went on to suggest that there could be no class recovery, even if the Ninth Circuit did reverse. J.A. 295-96. At oral argument, Delaware counsel drove that point home: "There is no class in the so-called 'federal class actions.' Thus, absent class members cannot, *in the present posture or in any posture that I can envision, have any benefit from that proceeding*. The

[52] Five pages were devoted to the state law claims; sixteen to *Epstein*. J.A. 290-292. Thus, the Delaware brief's subheadings are such arguments as "It is unlikely that the Ninth Circuit will find SEC Rules 10b-13 and 14d-10 provide a private right action." J.A. 293.

persons who might benefit, if at all, if a number of remote scenarios took place, would be the *individual* plaintiffs, and even there they must obtain a reversal of their decisions in that court." J.A. 226-227. These assertions were plainly false, as evidenced by the results of the *Epstein* appeal.

In terms of their impact on the Delaware proceedings, counsel's most significant misstatements concerned the district court's adverse finding on damages. The memorandum asserted that "*it is doubtful that the Ninth Circuit will overturn the Federal District Court's factual finding that Mr. Wasserman did not receive higher consideration....*" J.A. 295. This is a striking misrepresentation. Although the "findings" petitioners submitted *post hoc* to the district court's decision included a finding on damages (Pet. App. 50a, 58a-59a), [53] they never moved for summary judgment on damages (Pet. App. 19a-20a n.20), and *their briefs in the Ninth Circuit, made no effort to argue otherwise*. Cir. R. 27. The briefs were filed *before* the Delaware proceedings. Delaware counsel presented an obviously erroneous finding to the state court as though it were true, and petitioners' counsel made no effort to correct the misstatement.

Finally, we invite the Court's attention to the terms of the release. That release absolved Delaware counsel from any liability for their conduct in the Delaware litigation. Pet. App. 74a-75a. Surely, a disabling conflict of interest exists when class counsel releases federal claims in the circumstances shown here, and also

[53] That "finding" was contained in a document submitted by petitioners' counsel long after the court had granted summary judgment. Pet. App. 45a. Despite clear Ninth Circuit disapproval of the practice (*see Mattel, Inc. v. Hyatt*, 664 F.2d 757, 759 (9th Cir. 1981)), the court simply signed the document, after making three minor changes. D.R. 502 at 8, 11, 21. Although not revealed in the Joint Appendix, the "court's" findings were made on counsels' letterhead. *Compare* D.R. 502 to Pet. App. 45a.

simultaneously purports to preclude counsel's "clients" from any possibility of maintaining even a meritorious malpractice action.[54]

B. Inadequate Judicial Supervision. In approving the second settlement, the vice chancellor's conduct fell below the minimum standards required by due process if the rights of thousands of shareholders were to be effectively precluded on the basis of representation.

The vice chancellor, it will be recalled, had initially rejected the first settlement as "illusionary" (J.A. 171), and said that plaintiffs' state law claims were worthless. J.A. 167, 171. He recognized that the only beneficiaries of the first settlement proposed were Delaware plaintiffs' counsel. J.A. 170-71. Nonetheless, he approved the second settlement. Pet. App. 63a. Once again, he acknowledged that the state law claims were worthless. Pet. App. 68a. He gave no independent scrutiny to the merits of the federal claims. Pet. App. 27a. He recognized that the settlement's benefits were "meager." *Id. Far more important, however, he made no inquiry on the record as to the purported class representatives, or as to the adversarial character of the settlement proceeding*, even though he acknowledged "*suspicions*" *of "collusion."* He simply said, "Suspicion, however, is not enough and the objectors have offered no evidence of any collusion." Pet. App. 70a. The vice chancellor effectively shifted the burden of proof on matters where his inquiry was required, whether or not there were objectors.[55]

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[54] Space limitations preclude any extended analysis of the deficiencies in the proposed notice of settlement. The *Epstein* litigation was disparaged (Pet. App. 88a-90a), and more importantly, class members were wrongly told that they must pursue their claims *individually* in California. Pet. App. 96a.

[55] He was sufficiently troubled by the settlement, however, that he cut the request for counsel fees -- a request that itself was less than

The vice chancellor here was also the vice chancellor who presided in *Prezant*. In both cases, it is clear that he believed that, in the settlement context, the *only* issue involved in approval of a settlement was his judgment on its fairness. In neither case was he concerned about the existence of the class or the adequacy of its representation.[56] Adequate representation is, however, the fundamental legitimizing ground for all class actions. It must exist "*at all times.*" *Shutts*, *supra*, 472 U.S. at 812; *Prezant v. De Angelis*, *supra*, 636 A.2d at 923 (emphasis in original), and the judge must affirmatively satisfy himself of that fact. *Shutts*, *supra*, 472 U.S. at 809-10 (judge must "conduct an inquiry into . . . the adequacy of representation"); *Prezant*, *supra*, 636 A.2d at 923.

The "non-traditional character" of the class action is precisely the reason why a judge cannot act in as passive a role as would be allowable when all that is involved is a settlement between individual litigants.[57] The judicial duty to scrutinize is particularly imperative where classes are certified for settlement only. *Prezant v. De Angelis*, *supra*, 636 A.2d at 921 (after making clear the special dangers of abuse in settlement class

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counsels' initial request even though presumably they had done more work and they had now produced a "successful" settlement. Pet. App. 70a-72a.

[56] It should be recalled that, when the settlement is first proposed and notice issued, no finding regarding representation occurs. *See* J.A. 198-203. The purported representative acts solely as a result of a stipulation between the litigants. *Prezant*, *supra*, 636 A.2d at 923.

[57] *Protective Committee for Independent Stockholders v. Anderson*, 390 U.S. 414, 424 (1968) (making precisely this distinction in reorganization proceedings approving a compromise). *See also Carson v. American Brands, Inc.*, 450 U.S. 79, 88 n.14 (1981). "[A] court may not delegate to counsel the performance of its duty to protect the interests of absent class members." *Plummer v. Chemical Bank*, 668 F.2d 654, 659 n.4 (2d Cir. 1982); Newberg and Conte, *supra*, §1164 at 11-177. See also *Prezant*, *supra*, at 921; *General Motors*, *supra*, 55 F.3d at 805.

actions, the court emphasized the need for judicial participation because "*settlement of a class action is unique because [of] the fiduciary nature of the class action*"); *General Motors*, *supra*, 55 F.3d at 805 (describing "fiduciary responsibility" of courts, and "the need for a special focus on precluding the existence of collusion").[58] Judicial scrutiny is surely clearly imperative when, as here, the vice chancellor "made findings from which it may be inferred that [the class representative] is an *inadequate* class representative." *Prezant*, *supra*, 636 A.2d at 924.

* * *

Petitioners' only response to the due process objections is to assert that because the terms of the settlement were known and there was a right to opt out there can be no due process claim (Pet. Br. at 20-21). This is simply a corollary to their "contract" theory, and as we have observed the Delaware Supreme Court squarely rejected the *identical* argument in *Prezant*, and the very authorities upon which petitioners rely.[59] Viewed in terms of federal constitutional law, the theory is preposterous. Petitioners necessarily assert that a totally corrupt settlement is effective against those who do not flee.

The opt-out right does not substitute for adequate representation or adequate judicial supervision of the class action

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[58] In the settlement context, "[t]he court needs to be sensitive to the possibility that attorneys or parties have conflicts of interest." *Manual for Complex Litigation (Third)*, §23-14 at 171-72 (1995). Where classes are certified for settlement only, "closer judicial scrutiny (is required) than approval of settlements where class certification has been litigated." *Id.* at §30-45 at 243.

[59] In *Prezant v. De Angelis*, 636 A.2d at 924, as here, the settlement terms were known and there was a right to opt out. Defending the need for adequate representation, the Delaware Supreme Court said "We . . . reject defendants' assertion that notice and the opportunity to opt out without adequate representation, satisfies due process requirements."

proceeding. The opt out right accommodates those who want personal control of their claims; it does not substitute for protection of interests of absent class members though adequate representation and adequate judicial supervision of the class action settlement when that settlement is intended to bind absent class members. Moreover, for most persons an opt-out opportunity is largely illusionary, as *Prezant* recognizes.[60]

POINT III. The Delaware Settlement Release Proceeding Violated the Supremacy Clause

Petitioners (pp. 27-31) expend much argument on the protections accorded by "Our Federalism", but they utter not a word about state interference with federal law. Our federal system is a two-way street. At least since *McCulloch v. Maryland*, 17 U.S. (4 Wheat) 316 (1819), this Court has rejected efforts by states to interfere with the instrumentalities of the national government. In particular, the Court has long been sensitive to

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[60] *Prezant*, *supra*, 636 A.2d at 924 (opt-out rights "are infrequently used and usually economically impracticable"). "Only a small number of absent class members normally elect exclusion in Rule 23(b)(3) class actions." 3 Newberg and Conte, *Newberg on Class Actions*, §16.16 at 16-89 and n.204 (3d ed. 1992). This is true of securities litigation. Petitioners' Exchange Act opt-out refrain is really an argument that class actions to enforce liability are maintained at state court sufferance in the courts to which Congress gave exclusive jurisdiction.

Indeed, as a general matter, opt-out settlements exacerbate adequacy of representation problems because, in contrast to a 23(b)(2) settlement, those whose economic stake is greatest have a strong incentive to opt-out if they believe the settlement unfair. An opt-out was of no assistance to respondent Epstein. Although he owned one thousand shares, his individual claim was still too small to pursue even if defendants had conceded liability. D.R. 429, Ex. C.

impermissible state law intrusions on federal court jurisdiction.[61] The Court's decisions establish that a litigant's right of access to the courts of the United States is derived from the Constitution and Acts of Congress. "Petitioners being properly in the federal court had a right granted by Congress to have the court decide the issues they presented. . . . That right . . . cannot be taken away by the State." *Donovan*, *supra*, 377 U.S. at 413. Whatever the general efficacy of Delaware efforts to affect Exchange Act rights, this proceeding could not do so because that result would contravene the supremacy clause (Art. VI).[62] Fundamental principles of "Our Federalism" mandate that conclusion.[63]

The state proceeding convened by these petitioners and Delaware counsel was a manifest interference with the exclusive authority of the courts of the United States. No substantial state claims existed and they were not being prosecuted in any way. Pet. App. 68a. Moreover, the state law claims did not overlap

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[61] The Court has rejected efforts by state legislatures to confine litigation to the state courts. *E.g.*, *Railway Co. v. Whitton's Administrator*, 80 U.S. (13 Wall) 270 (1871); *Terral v. Burke Construction Co.*, 257 U.S. 529 (1922). And it has similarly rejected state court injunctions against proceedings in federal courts. *Donovan v. Dallas*, 377 U.S. 408, 413 (1964); *General Atomic Co. v. Felter*, 434 U.S. 12, 17-19 (1977).

[62] *Newton v. Rumery*, 480 U.S. 386 (1988), is instructive here. There, a 5-4 majority refused to fashion a general rule that prohibited contractual release of §1983 claims in exchange for dismissal of criminal charges. *Id.* at 394-97. But all members of the court recognized that the general rule did not preclude challenge to *a specific* release. *Id.* at 401-02.

[63] *Younger & Harris*, 401 U.S. 37, 44 (1971). This assumes that somehow the state court order purports to discharge the federal claims. If the court views the issue as we believe it should, *i.e.*, what effect should be given to a representative's contract release of federal rights, then this argument applies *mutatis mutandis*.

with respondents' claims against petitioners. The entire thrust of the state court settlement proceedings centered on evaluating respondents' *federal* claim (J.A. 289-97), *a fact that alone justifies rejection of the state proceeding on preemption grounds*. If these Delaware settlement proceedings were not a direct attempt to exercise the powers reserved by § 27 to the judges of the United States, no such case will ever arise.

There is, however, an even deeper and more constitutionally offensive pattern disclosed here. Petitioners and Delaware counsel sought to remove the Ninth Circuit appeal to Delaware. The Delaware proceedings in this case are not an illustration of a good faith "race to judgment" between federal and state courts that is an inescapable feature of "Our Federalism." The state law proceeding was not being prosecuted "in any way." J.A. 79. The sole purpose of the settlement proceeding was to permit petitioners and other counsel to destroy the good faith class litigation of federal claims within the exclusive jurisdiction of the federal courts. The mechanism employed was contrived *post-hoc* state class action settlement of worthless and abandoned state law claims. Respondents were putative federal class fiduciaries, and their federal claims were on appeal. They were not obliged to surrender to petitioners' desire to convert a federal proceeding into a state one. If petitioners are successful, this would amount to a removal of the federal appeal to the Delaware court and force respondents to secure a *revocable* license from the state court to proceed further in a court of the United States.[64] What is more

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[64] To proceed further with their federal appeal, respondents would be required to go to Delaware and convince that court of one of two propositions: (a) that Delaware lacks power to affect the federal claims; or (b) the settlement itself was unfair. If Delaware rejected their claims, they would have to resort to Delaware appellate process, and ultimately review here. *Martin v. Wilks*, 490 U.S. 755, 763-764 (1989). (Even if respondents prevailed on the first objection, the same gauntlet must be

this entire process could be replicated elsewhere.[65] To some extent, as we have said, the race to judgment is a feature of Our Federalism. Not so here. To give effect to this Delaware proceeding would be profoundly contrary to our constitutional traditions.[66]

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run.) If they prevailed on the second objection, they faced the possibility of returning to Delaware yet another time to object to yet another settlement by class representatives other than themselves. In either event, respondents would through a form of involuntarily joinder now be subject to in personam jurisdiction and the ability to conduct further federal proceedings exist would be at sufferance of the Delaware class representative.

[65] As a practical matter, no other effective way exists to protect the federal rights here other than to deny the settlement/judgment preclusive effect. Plaintiffs' ability to secure protection from the lower federal courts is doubtful and burdensome. The power of the federal court to enjoin a pending state lawsuit (however dormant in fact) is limited by 28 U.S.C. §2283. While §2283 permits such an injunction "in and of its jurisdiction", this is a narrow exception. *Atlantic Coast Line R.R. Co. v. Brotherhood of Locomotive Engineers*, 398 U.S. 281 (1970), makes plain that this narrow exception is not triggered simply because exclusive jurisdiction was in a federal forum. This is so, "even when [the state] interference is unmistakably clear." *Id.* at 294. *See also Chick Kam Choo v. Exxon Corp.*, 486 U.S. 140, 149 (1988). Moreover, there is a natural federal court reluctance to enjoin state proceedings, especially where, as here, our claim of interference depended upon a prediction that a vice chancellor who had already rejected one settlement as illusionary would nonetheless approve a second. There, moreover, are *bureaucratic* problems of getting a motion panel together and focused on the topic. (Indeed, we moved to advance argument in our case because of the Delaware proceeding. That tepid motion never even made it out of the clerk's office. J.A. 126; J.A. 127.) Finally, the whole injunctive process would result in a distracting side bar diversion over whether an injunction was -- or was not -- appropriate, further delaying proceedings.

[66] Lines may have to be drawn in other cases, but that is the nature of the adjudication. "[W]here to draw the line . . . is the question in pretty much everything worth arguing in the law." *Irwin v. Gavit*, 268 U.S. 161, 168 (1925) (Holmes, J.). If there is any line at all, this Delaware settlement judgment is clearly on the wrong side.

While rejection of *this* state settlement proceeding could be understood as an interpretation of the Congressional grants of jurisdiction to the federal courts, or as a matter of federal common law implementing those grants,[67] we believe, however, that the ground for rejecting the Delaware proceedings is the same as in *McCulloch*: inferences drawn from the structure and relationship of the national government. 4 Wheat at 426 *et seq.*[68] The Constitution of the United States does not contemplate the direct assault this record disclosed upon the jurisdiction conferred by Congress on the courts of the United States.[69]

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[67] The preclusive effect of federal court judgments on federal claims has long been governed by federal common law. 18 Wright & Miller, *supra*, at §4466. Moreover, even courts most receptive to state court release of federal claims recognize that the effectiveness of a release must pass muster under *federal* standards. *Newton v. Rumery*, *supra*, 480 U.S. at 392. Surely, § 27 and §1291 can sponsor limited federal common limits on state preclusion rules given the important federal interest in protecting the jurisdiction of the federal court. *See Boyle v. United Technologies Corp.*, 487 U.S. 500, 504 (1988). In fact, jurisdictional grants have been read to authorize the creation of whole bodies of substantive law. "Three [admiralty, interstate controversies, and §301 of Taft Hartley] of the most celebrated instances of law-making power by the federal courts are based on jurisdictional grants." Hart & Wechsler, *supra*, at 883.

[68] Charles Black, *Structure and Relationship in Constitutional Law* (1965); Henry P. Monaghan, *Constitutional Common Law*, 89 Harv. L. Rev. 1, 10-18 (1974).

[69] *See Deposit Guar. Nat'l Bank v. Roper*, 445 U.S. 326, 353 n.12 (1980), where *federal* defendants unsuccessfully sought to preclude a class action by buying out the named plaintiffs by (unlike this case) tendering the plaintiff the maximum amount he could have recovered. The Court noted it could protect its authority "if a class action defendant were shown to have embarked on a course of conduct designed to insulate the class certification issue from appellate review in order to avoid classwide liability." What happened here is indeed far more constitutionally offensive than what happened in *Donovan*, *supra*, which provided "as strong as case as can be imagined for a state court injunction against federal *in personam* proceedings." Hart & Wechsler, *supra*, at 1331.

CONCLUSION

The judgment should be affirmed.

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Respectfully submitted,

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Under Texas law municipal bonds could not be issued so long as there was pending litigation challenging their validity. After the state courts had rejected the challenge, 27 of the state court litigants (and others) commenced an action in federal court making the same challenge. This court nonetheless held that the state court could not interfere with the federal proceeding. *Donovan*, *supra*, 377 U.S. at 411-414.